1985 Dodge/Sweet's Construction Outlook

First Update
March 1985

Reaching For The Peak

The building market is doing what it usually does during the middle years of its cyclical development: It is moving over to the slow lane.

1983 and 1984 were the years of maximum acceleration. From almost a dead stop that lasted from 1980 to 1982 (when the value of new construction contracting failed to break out of the $150 to $160 billion range), contracting leaped 23 percent in 1983 to $194 billion. That surge was followed by an 8 percent gain in 1984 to $210 billion. From there the numbers will keep getting bigger for a while longer, but the gains will continue to diminish. The 1985 advance will shrink to 5 percent as total construction contract value reaches $221.0 billion, and will be followed by a mere 2 percent increase in 1986.

After adjustment for inflation, *real* (constant dollar) expansion of the construction cycle will be reaching its limit in 1985, and by 1986 the building market will be rounding another peak. This means that the next two years—1985 and 1986—are likely to be the best of the current crop.

What To Watch For in '85

Last year opened with strong housing activity (which subsequently faded), and closed with equivalent strength in nonresidential building. The emergence of the dormant commercial and industrial building sector—a more or less normal mid-cycle event—was what kept the construction market's two-year-old expansion alive.

As 1985 opened, construction contracting continued to advance—from December's $211 billion (seasonally adjusted annual rate) to $215 billion in January. But in January it was homebuilding (and also public works construction) that moved the market ahead, while nonresidential building settled back. After last year's 24 percent surge of commercial and industrial building, January's shift could be the signal for another change of emphasis—this time in favor of residential building.

Two market pressures—one positive and the other negative—lend support to such a reversal. On the plus side: Single-family homebuilding has yet to respond to the decline of mortgage rates that has been under way since late last summer. (January's housing gain was exclusively in multi-family units.) This potential should be coming through in 1985. The minus: Office building is highly vulnerable, and may already be on the way to an extended correction for the overbuilding that has been encouraged by accelerated depreciation. These two categories, one-family housing and offices, are the ones to watch closely in 1985.

Commercial Building: A Premature Peak

The current cycle of commercial and industrial building is taking on a unique configuration. In contrast to the typical pattern of steady expansion over a period of three or more years, followed by sharp contraction, this cycle—which began late in 1982—appears to have topped out after only eight quarters of expansion. Its premature peak is a low one by recent standards, but should be followed by an unusually gentle decline stretching over the next several years. The reason: divergent movements in the three major components of commercial and industrial building.

For the next few years, retail building will be holding steady at its current 425 to 450 square foot rate of contracting. Office building, which soared to 330 million square feet in 1984 II, is now edging down and its decline will soon accelerate. Industrial building, temporarily stalled at just short of 150 million square feet, has the potential to climb to 200 million square feet before the next recession sets in.

Because the anticipated decline of office building will carry considerable weight in the near future, the direction of total commercial and industrial building will be generally downward through the mid-1980's, but the continued support of

retail and industrial building will cushion the fall. The net result: an almost plateau-like appearance to the total commercial and industrial building market through 1987. Ultimately, as the economy slips into general recession toward the end of the decade, the cyclical decline of commercial and industrial building will degrade into a typical across-the-board retreat. For the short term, however, recession is not a serious threat. With capacity utilization at 82 percent and unemployment at 7 percent, the economy has plenty of room to grow, and more than enough deficit spending to keep it growing.

Contracting for retail buildings (stores and warehouses) reached a rate of 420 million square feet in 1984's second half, a level that is consistent with a volume of housing starts in the range of 1.7 million to 1.8 million units. Since 1.8 million dwelling units is the best expectation for the housing sector any time in the foreseeable future, it would appear that retail building has gone about as far as it is going for a while.

Because the volume of homebuilding is likely to remain close to 1.8 million units through 1985 and 1986, the demand for retail building is headed for an extended stretch of contracting at its present high level. Allowing for a short lag (which has the effect of smoothing out quarter-to-quarter variations in homebuilding as demand is subsequently transferred to retail building), contracting for stores and warehouses is estimated to hold steady in the narrow range of 420 million to 430 million square feet for the next two years.

In response to the economy's vigorous 1983-84 recovery, and encouraged by tax incentives, contracting for industrial construction surged 60 percent between 1983 I and 1984 II. For the rest of 1984, however, contracting for manufacturing buildings remained frozen in its tracks. The reason: The brief round of monetary restraint that was applied to check the economy's runaway expansion inevitably led to a dip in industrial production and a setback in capacity utilization.

The general economic outlook for 1985 has brightened appreciably in the past month or two, but last year's close encounter with "growth recession" is likely to eclipse the industrial building market through the first half of the year. In 1985, the completion of last year's large increase of newly started industrial construction, along with slower industrial growth and continued problems in export markets for U.S. manufacturers, will combine to hold the capacity utilization rate below 83 percent. Under such circumstances, contracting for new plant capacity will be inhibited until some of the current surplus is absorbed. In 1985, this implies a year of only modest improvement in industrial construction, and the short-term forecast has been scaled down to 150 million square feet (up 5 percent from 1984's 143 million). Most of this gain will be concentrated in the second half.

For the second time in the 1980's the office building boom appears to be receding from an extraordinary peak. The first one came in 1981:I when the rate of contracting soared to a record 355 million square feet. A year later, as the booming Southwest began to cool down, contracting for office buildings was declining sharply. But a little more than a year after that, the stimulus of greatly liberalized depreciation schedules triggered a secondary building boom in major cities and their suburbs all over the nation.

1985 National Estimates Dodge Construction Potentials

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		1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings				
Floor Area (millions of square feet)	Office Buildings	317	275	– 13
	Stores & Other Commercial	477	496	+ 4
	Manufacturing Buildings	143	150	+ 5
	Total Commercial & Manufacturing	937	921	– 2
	Educational	89	95	+ 7
	Hospital & Health	71	72	+ 1
	Other Nonresidential Buildings	122	132	+ 8
	Total Institutional & Other	282	299	+ 6
	Total Nonresidential Buildings	1,219	1,220	—
Contract Value (millions of dollars)	Office Buildings	$ 22,917	$ 20,975	– 8
	Stores & Other Commercial	18,465	19,800	+ 7
	Manufacturing Buildings	7,141	7,650	+ 7
	Total Commercial & Manufacturing	$ 48,523	$ 48,425	—
	Educational	$ 7,569	$ 8,125	+ 7
	Hospital & Health	7,217	7,550	+ 5
	Other Nonresidential Buildings	9,959	10,700	+ 7
	Total Institutional & Other	$ 24,745	$ 26,375	+ 7
	Total Nonresidential Buildings	$ 73,268	$ 74,800	+ 2
Residential Buildings				
Dwelling Units* (thousands of units)	One-Family Houses	1,001	1,050	+ 5
	Multi-Family Housing	747	725	– 3
	Total Housekeeping Residential	1,748	1,775	+ 2
Floor Area (millions of square feet)	One-Family Houses	1,578	1,648	+ 4
	Multi-Family Housing	714	707	– 1
	Nonhousekeeping Residential	92	90	– 2
	Total Residential Buildings	2,384	2,445	+ 3
Contract Value (millions of dollars)	One-Family Houses	$ 66,849	$ 73,325	+10
	Multi-Family Housing	27,597	28,625	+ 4
	Nonhousekeeping Residential	6,425	6,500	+ 1
	Total Residential Buildings	$100,871	$ 108,450	+ 8
Nonbuilding Construction				
Contract Value (millions of dollars)	Highways & Bridges	$ 17,158	$ 18,025	+ 5
	Sewer & Water	8,098	8,600	+ 6
	Other Public Works	8,143	8,125	—
	Total Public Works	$ 33,399	$ 34,750	+ 4
	Utilities	$ 2,485	$ 3,000	+21
	Total Nonbuilding Construction	$ 35,884	$ 37,750	+ 5
All Construction				
Contract Value (millions of dollars)	Total Construction	$210,023	$221,000	+ 5
	Dodge Index (1977 = 100)	149	157	

*F.W. Dodge basis

1985 Regional Estimates
Dodge Construction Potentials

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Northeast

CT, ME, MA, NH, NJ, NY, PA, RI, VT

Contract Value (millions of dollars)	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$ 8,183	$ 7,950	− 3
Institutional and Other	4,467	4,800	+ 7
Total	$12,650	$12,750	+ 1
Residential Buildings			
One-Family Houses	$ 8,665	$ 9,675	+12
Multi-Family Housing	3,598	3,750	+ 4
Nonhousekeeping Residential	880	900	+ 2
Total	$13,143	$14,325	+ 9
Nonbuilding Construction			
Highways and Bridges	$ 3,246	$ 3,200	− 1
Other Public Works	3,119	3,300	+ 6
Utilities	314	400	+27
Total	$ 6,679	$ 6,900	+ 3
Total Construction	$32,472	$33,975	+ 5

South

AL, AR, DE, DC, FL, GA, KY, LA, MD, MS, NC, OK, SC, TN, TX, VA, WV

Contract Value (millions of dollars)	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$18,536	$18,800	+ 1
Institutional and Other	9,444	9,900	+ 5
Total	$27,980	$28,700	+ 3
Residential Buildings			
One-Family Houses	$30,230	$32,600	+ 8
Multi-Family Housing	12,384	12,450	+ 1
Nonhousekeeping Residential	2,732	2,825	+ 3
Total	$45,346	$47,875	+ 6
Nonbuilding Construction			
Highways and Bridges	$ 6,128	$ 6,525	+ 6
Other Public Works	5,833	6,000	+ 3
Utilities	1,394	1,500	+ 8
Total	$13,355	$14,025	+ 5
Total Construction	$86,681	$90,600	+ 5

North Central

IL, IN, IA, KS, MI, MN, MO, NE, ND, OH, SD, WI

Contract Value (millions of dollars)	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$ 9,416	$ 9,475	+ 1
Institutional and Other	5,167	5,400	+ 5
Total	$14,583	$14,875	+ 2
Residential Buildings			
One-Family Houses	$10,720	$11,775	+10
Multi-Family Housing	3,555	3,450	− 3
Nonhousekeeping Residential	925	775	−16
Total	$15,200	$16,000	+ 5
Nonbuilding Construction			
Highways and Bridges	$ 4,766	$ 5,025	+ 5
Other Public Works	3,699	3,775	+ 2
Utilities	203	300	+48
Total	$ 8,668	$ 9,100	+ 5
Total Construction	$38,451	$39,975	+ 4

West

AK, AZ, CA, CO, HI, ID, MT, NV, NM, OR, UT, WA, WY

Contract Value (millions of dollars)	1984 Actual	1985 Forecast	Percent Change 1985/84
Nonresidential Buildings			
Commercial and Manufacturing	$12,388	$12,200	− 2
Institutional and Other	5,667	6,275	+11
Total	$18,055	$18,475	+ 2
Residential Buildings			
One-Family Houses	$17,234	$19,275	+12
Multi-Family Housing	8,060	8,975	+11
Nonhousekeeping Residential	1,888	2,000	+ 6
Total	$27,182	$30,250	+11
Nonbuilding Construction			
Highways and Bridges	$ 3,018	$ 3,275	+ 9
Other Public Works	3,590	3,650	+ 2
Utilities	574	800	+39
Total	$ 7,182	$ 7,725	+ 8
Total Construction	$52,419	$56,450	+ 8

Tax reform proposals that are apt to take back some of the incentive of accelerated depreciation add an extra element of mystery to the outlook, but such legislation is at least a year from becoming effective. In the meantime, the office market must be evaluated on the basis of current conditions.

By conventional standards, this market was overbuilt as long ago as 1981, and one consequence of accelerated depreciation was to raise the threshold of saturation. What was surplus by pre-ERTA standards became acceptable with liberalized depreciation. After three extra years of high-volume development, it is probably safe to say that the market is as overbuilt today—with the new depreciation schedules—as it was in 1981 under the former rules. If 1982's short-lived decline of contracting was any indication of developers' reaction to overbuilding, then a cutback of perhaps 15 percent (to 275 million square feet) might be appropriate for 1985's nervous market. An even larger decline would seem reasonable except for the motivation to continue building in anticipation of tax reform.

For the past two years, state and local governments have been learning how to get along with less financial help from Washington. The initial shock of the New Federalism, coming as it did when the

economy was in deep recession, led to sharp cuts in contracting for institutional building during 1981 and 1982. Recovery, which began in 1983, has been a slow process, and the future of the institutional building market (schools, hospitals, public administration buildings, etc.) depends on the capability of state and local governments to go it alone.

Over the next several years, the most positive influence on institutional building will be the gradual strengthening of demographic support in the key educational sector. The biggest risk: the likely loss of Federal Revenue Sharing funds. However, neither of these two factors will have much bearing on 1985's outcome when the continued recovery from the 1981-82 collapse will raise contracting another 6 percent to just under 300 million square feet—still below pre-1980 levels.

The 1985 forecast of total nonresidential building (commercial, industrial, and institutional building) has been increased slightly to 1,220 million square feet—a volume that is virtually even with 1984's final total. A different "mix" of building types in 1985 (fewer offices, more institutional buildings), along with an average increase in cost per square foot of 4 to 5 percent, will raise nonresidential building contract value 2 percent to $74.8 billion.

Housing: A Second Effort

The closing quarters of 1984 brought the anomaly of declining mortgage rates *and* declining housing starts. Usually when one is going down, the other is going up.

Whether the lack of homebuyer response to improving credit conditions was due to general economic uncertainty during last year's shaky second half, or the hope that still lower rates might be negotiated by holding out longer, the time to act has arrived. After its brief slowdown, the economy is back to cruising speed. Partly for that reason, interest rates are stabilizing. With homebuyers running out of reasons not to buy, it has become fashionable to look for the turnaround of the housing market in 1985's first quarter, with continuing recovery throughout the rest of the year.

Although short-term interest rates are stabilizing, mortgage rates can still edge downward a bit more. The average mortgage commitment rate, which is currently a shade under 13 percent (down from 14 percent at this time last year), is expected to decline for perhaps another quarter, leveling off between 12½ and 12¾ percent through the second half. By 1986, mortgage rates—preceded by rising short-term rates—are likely to be climbing into the 13's again.

The experience of the first half of the 1980's, a period when mortgage rates ranged from high to very high, is the best guide to the potential of the one-family housing market when mortgage rates fluctuate between 12 and 13 percent. Within this range, the credit-sensitive one-family building market cannot stretch much beyond 1.1 million units, and can also be squeezed below 1.0 million, where it is now.

Early in 1985, one-family housing starts will reverse their 1984 decline, edging past the one million unit rate in the spring quarter to finish the year at 1.1 million units. For 1985 as a whole, the expected volume of 1,050,000 one-family units would be the best of the 1980's to date—slightly better than the 1.0 million volume reached in both 1983 and 1984, and well above the depressed level that prevailed during 1980, 1981, and 1982.

Multi-family building, at a very strong 700,000-plus unit volume in 1983 and 1984, is being supported by two layers of demand—one firm, but the other undependable. Condominiums, which now make up one-third of total multi-family starts (up from one-tenth only a few years ago), have found a secure niche as the 1980's alternative to the traditional "starter home." But apartment construction, having soared into the unreal world of tax shelters since 1982, is, like offices, becoming overextended.

With accelerated depreciation continuing to support apartment building for at least another year, and lower interest rates stimulating condo sales, 1985's total of multi-family building can be expected to remain within its recent high range of 700,000 to 750,000 units. January's strong rate of contracting got 1985 off to a good start.

Total housing starts in 1985, consisting of 1,050,000 one-family homes and 725,000 multi-family units, are estimated at 1,775,000—a small increase over 1984's 1,748,000 units. Including nonhousekeeping residential buildings (hotels, motels, dormitories), total residential construction contract value will increase 8 percent in 1985 to $108.5 billion.

Public Works: Budgetary Discipline

The ICE issue, which has been threatening to disrupt highway construction for the past year, finally appears to have been resolved. But this does *not* mean that highway bridge construction is about to surge as a large block of "frozen" Federal funds is suddenly released.

It is a fact, of course, that Congress' reluctance to pass DOT's Interstate Cost Estimates (due to controversial amendments to the bill, and not because of the estimates themselves) has delayed the disbursement of several billion dollars of Federal grants for Interstate highway construction. Contracting for highway construction has not been seriously interrupted, however, mainly because state governments were able to advance the funds necessary to keep most projects moving ahead. Despite all the concern, 1984 contracting for highways and bridges was *up 13 percent* over 1983's previous record value.

The release of the blocked Federal funds in the months ahead will be of greater interest to the keepers of state and Federal government accounts than to contractors. As funds that were advanced by state highway agencies are replaced by Federal grants, 1985 contracting is likely to be close (or only slightly higher) than it would have been had the ICE issue never happened—a total of $18.0 billion for a gain of 5 percent over 1984's contract value.

The attempt to conform with last summer's Deficit Reduction Act will keep a tight lid on Federal spending for water resources (Corps of Engineers and Bureau of Reclamation) and for waste water treatment plants (Environmental Protection Agency). However, construction of water supply systems, which depends more on municipal funding, is expected to rise nearly 10 percent in 1985 in line with generally strong building activity. On balance, total public works construction will not quite keep pace with inflation in 1985, as the expected 5 percent rise in construction cost exceeds this year's 4 percent advance of contract value to $34.8 billion.

Total nonbuilding construction contract value (public works and utilities) will advance 5 percent in 1985 to $37.8 billion.

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